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SUBJECT: BRAZIL'S PENSION ("PREVIDENCIA") PROBLEM: A BASIC PRIMER

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#### SUMMARY AND COMMENT

1. Lula's GoB is set to tackle the abysmal fiscal problem of Brazil's pension system (current budget drain: five-plus percent of GDP.) Of that system's total deficit in 2002, its three million public-sector pensioners accounted for Rs 53 billion; its 20.8 million private sector retirees for just Rs 18 billion. The incoming GoB's plan, outlined by long-time Lula confidant Luiz Gushiken, hinges on: (i) unifying the private- and public-sector pension systems for all future entrants to Brazil's workforce; and (ii) limiting all pensions to a common eventual ceiling. This means deep future slashes in public-sector pensions. With these goals, Lula's administration is turning its back on PT history. Throughout Cardoso's presidency, the PT opposed attempts to reform the pension system, especially the notion of public-sector pensions being anything less than "integral" (100% of final salary).

2. Pushing these policies now will mean a huge fight with Brazil's entrenched public sector. And these days the PT's membership is said to be as -- or more -- numerous amongst mid-to-lower level government functionaries as amongst factory workers. Thus, pension reform represents a big early choice for Lula between past trade-union loyalties and current fiscal exigency. Even if successful, it would not start to accrue big GoB budget savings for years. Yet in terms of keeping Brazil's sovereign debt sustainable, GoB pension reform in 2003 can reasonably be seen by the longer-sighted component of 'the market' as no less crucial than ongoing GoB primary surpluses.  
END SUMMARY AND COMMENT.

#### Nature of Problem: Maharajahs and A Fiscal Crater

3. Even in advance of Lula's December 20 designation of PT Sao Paulo Deputy Ricardo Berzoini (PT-SP) to head "Previdencia" (Social Security Administration equivalent), the incoming GoB was leaving little doubt that it has resolved to tackle Brazil's infamous pension-system fiscal problem. Tax reform was Lula's earliest declared legislative priority for the new Congress, but all his most senior PT aides (Palocci, Dirceu, Genoino, Mercadante, Genro) now publicly chorus that Previdencia's overhaul is the vital pre-condition for salvaging the GoB's fiscal situation in the medium-to-long run. During and since Lula's inauguration, the GoB drumbeat on the theme has intensified. "Without fixing Previdencia, no other budget issue will be solved," Finance Minister Palocci has summed up, and he highlighted the issue both to USTR Zoellick on January 1 and in his speech at the January 2 ceremony when taking over the Finance Ministry sash.

4. As well he might. The consolidated Brazilian government's current annual mismatch between Previdencia receipts and outlays is a robust 70-plus billion Reals (\$20-plus billion.) That exceeds five percent of GDP. It is one-sixth of gross tax revenues. For comparison: in 2001, Brazil's federal government spent a total of Rs 44 billion on all its health, education and security programs, and total federal investment was under Rs 8 (eight) billion (admittedly not including state companies like Petrobras). Separate out pensions, and Brazil would be running not just a primary but also a nominal budget surplus, even while paying more than 8 percent of GDP in interest yearly.

5. This fiscal crater was dug by Brazil's public-sector pensioners. The latter number some three million, from Brazil's federal government plus those of its 26 states and 5,500 municipalities. They all get an "integral" pension, i.e., equal to their top lifetime salary (more, in some cases), paid out of the budget of the corresponding government level. Nor is there any ceiling to these public-sector pensions. Public employees began paying into their own pension fund only after 1992; they now have just 11% of salary deducted.

6. Brazil's 20.8 million private-sector retirees under the national social-security scheme (INSS) also pay up to 11% of their salaries on a sliding scale on the first Rs 1,561 of their monthly salaries. But their employers must pay INSS an extra 20% of payroll as extra contribution towards the whole Previdencia system. (That in turn helps depress the ratio of

Brazil's working population with "carteira assinada," i.e., working on the books as part of the formal, tax-paying economy, to an estimated 45-50% -- a further problem.) Private-sector workers wind up with a mere fraction of their salaries as pension, computed via a complex formula based on years worked, remaining life expectancy, lifetime average salary, et al. And they max out at just Rs 1,561 (ten so-called 'reference minimum salaries') per month.

17. Bottom line: Previdencia's total yearly deficit for the consolidated Brazilian government in 2002 was Rs 70-plus billion (\$20-plus billion), i.e., 5.2% of GDP, roughly two-thirds in the Federal budget, and the rest in states' and municipalities'. Of this total, Rs 53 billion was spent on public-sector retirees, and just Rs 18 billion on private-sector ones. According to the GoB's own computations, each public-sector retiree costs the budget Rs 14,590 per year, vs. Rs 656 (sic) per private-sector retiree.

18. The disparity further narrows down to 600,000-900,000 of Brazil's best-paid civil servants, its so-called "maharajahs." Even under the current system, according to one analysis, 80% of public-sector retirees are due pensions beneath the private-sector cap of Rs 1,560. It is thus the remaining 20% -- i.e., one in perhaps thirty Brazilian pensioners -- who make off with most of the gravy. Most egregiously, these "maharajahs" are concentrated in the legislature and Justice Ministry, where the medium salary is reputedly Rs 5,500. Their reported average monthly pension is Rs 8,000.

#### Past Reform Efforts: FHC's Failure

19. Former president Cardoso launched a constitutional amendment for Previdencia reform at the outset of his first term in 1995. Eight years later, supporters claim FHC was largely successful in containing costs on the private-pension (INSS) side, but concede that results on the public-sector side were marginal. FHC did raise the standard required length of service to 30 and 25 years, respectively, for men and women. He also introduced the principle of longevity not just of work but of payments into the Previdencia system as the basis for pension eligibility.

110. The closest FHC came to a breakthrough was in 1998, when a majority in Congress approved a bill that inter alia raised public servants' contribution to Previdencia from 11 to 25% of salary on a sliding scale, and introduced (at IMF insistence) the principle that retirees also pay towards the system. A preliminary Supreme Court injunction, however, then declared such measures to be "confiscatory" and thus to require approval by a three-fifths legislative vote under the constitution. The Court's final decision on the subject is still pending.

111. Thereafter, FHC's pension-reform efforts subsided. True, his GoB finally procured its constitutional amendment in 1998. But that amendment only passed after being stripped of its reform teeth on the public-pension side. As with the general fiscal-reform inertia of FHC's second term, a prime cause was that he had traded too many legislative chips to obtain the constitutional amendment which let him be re-elected. Yet the outgoing GoB can also rightly charge that the PT then opposed and blocked pension reform at every turn.

#### PT's About-Face, Pension-Reform Premises

112. So the new GoB's plans for basic reform were far from predictable. Their design, as presented in post-election media accounts, is attributed to Lula's deputy transition coordinator, long-term core confidante, campaign coordinator in the 1994 and 1998 presidential races, and now Secretary for Communications, Luiz Gushiken. Apart from his personal bond with Lula, Gushiken comes substantively well-armed. His private consulting company specializes in social-security and pension matters. Health problems reportedly precluded him from being put in charge of Previdencia, but his second-in-command at the company, Augusto Tadeu Ferrarri, is presumed likely to be involved in advancing the reform campaign.

113. NOTE: Lula's first-round rival and second-round supporter in the presidential race Ciro Gomes was said to want the Previdencia job keenly. However, Ciro's own proposals for pension reform, as enunciated during the campaign, were for a system of individual retirement accounts, the transition to which by common professional agreement would have been financially insupportable -- "two to three (Brazilian) GDPs," according to Gushiken's firm. Lula made Ciro Minister of National Integration instead. Previdencia went to Berzoini, a 42-year-old PT congressman and former bank-employee labor leader with little apparent executive experience. END NOTE.

114. The reform plan's twin premises are: (i) unification of the private INSS and public-sector pension systems for all future entrants to Brazil's workforce; and (ii) a common future ceiling for all pensions. That ceiling is putatively to be fixed via negotiations with all affected parties by the GoB. The official suggestion for now is that it should be somewhere

between Rs 1,561 (the ten 'minimum reference salaries') and twenty times the minimum salary (currently Rs 200, but due to be raised at least to Rs 220.) As first publicized, the PT plan seemed to accept that Brazil's already-retired ("inativos") cannot be made to contribute to the pension system. However, new Previdencia chief Berzoini has begun to hint otherwise.

15. What about Brazil's not-yet retired? Previous debate on pension reform has featured the rote GoB promise to respect "acquired rights" -- code meaning that the rules of the game will not be changed in mid-career for current public functionaries. In a new twist, though, PT party leader Genoino and others now intone that "acquired rights" (i.e., pensions already being paid to retirees) are not the same as "acquired expectations" (i.e., current workers' assumption that their eventual pensions will be computed per the old basis.) There is now the suggestion that current public-sector employees will see their eventual pensions diminished on a sliding scale from 10 to 40% of the "integral". Only if some such change is installed, of course, can the GoB realize major fiscal savings anytime before the end of the working lifespan of functionaries not yet even in the system -- i.e., three decades hence.

16. Lula thus seems positioned to place himself in favor of a more radical Previdencia transformation than FHC ever attempted. In so doing, he and the new GoB will be turning their backs on the PT's own history. The latter is replete with resistance to public-sector pension reform and to the notion of those pensions being less than "integral". Pushing for such changes now will mean a tough battle with Brazil's entrenched, well-organized public-sector unions. The latter now loom large in Brazil's labor movement generally, with the PT said to have as much or more of a numerical base in mid-to-lower level government workers than amongst factory workers. Thus, the issue involves an early choice for Lula between past party loyalties and current fiscal exigency.

Prospects: Better than Before

17. For now, the GoB leaders' byword is 'consultation.' All are on-script in saying that social consensus for pension reform should and will be arrived at via mass public dialogue. The head of Lula's new "town-hall" Economic and Social Development Council (Rio Grande do Sul's PT ex-governor Tarso Genro) has said that producing a consensus on Previdencia will be his Council's top task in the coming year. As to why beneficiaries of the status quo should agree to forfeit any 'rights', the new GoB argues that consensus will arise when all realize that to keep the system alive as is will bankrupt it, bringing worse losses for all.

18. Conversely, the question arises: why would public-pension reform not/not be a sure-fire political winner for any GoB, given that it could be painted as a simple matter of Brazil's 'maharajahs' vs. its general population? The answer seems to be that even for lower-paid functionaries -- federal, state and municipal -- "integral" pensions are a major, built-in life expectation.

19. There is no guarantee that Brazil's more center/right political parties which voted for pension reform before in Congress will necessarily do so again in support of a PT version. And key questions such as whether "inativos" may be made to pay into Previdencia remain to be judged by the Supreme Court. Most thus expect the fight on the Previdencia reform front to be steeply uphill. Yet we also already hear some optimistic predictions, including from new Central Bank Chairman Meirelles to Ambassador in their January 8 meeting (Septel), that pension reform this year has good chances, given Lula's landslide, his reserves of popular enthusiasm, and the fact that the well-disciplined PT will now support it.

Lula Sets Timetable

20. On January 7, Lula formally directed Berzoini together with Economic and Social Development Counsel (ESDC) chief Genro to initiate the Previdencia reform campaign by February. Over the following ninety days, Berzoini is to engage in broad, country-wide discussions with politicians, businessmen, labor, public servants, and NGOs. He is to report the results to the ESDC, which will harmonize public suggestions with the main lines of the GoB's own draft design. Proposals based on the results of this process are to be presented to Lula in May, so as to be worked into a bill for presentation to Congress before summer adjournment.

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